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The Chinese economy, seen from Japan and the Netherlands

This paper assesses the consequences of the rapid Chinese economic development for Japan and the Netherlands. China has become the most important supplier of import goods for Japan and the fourth most important one for the Netherlands. With two-thirds of Dutch imports from China being re-exported, the emergence of China has enhanced the role of the Netherlands as European distribution centre. As for exports, China is now a major market for Japan, but not for the Netherlands. This is in line with gravity models of foreign trade. The same holds for differences in foreign direct investment (FDI), with Japan the biggest investor in China and the Netherlands a minor one. The emergence of China has increased purchasing power of Japanese and Dutch households, while its effects on labour markets and income distribution are relatively modest. In spite of differences between Japan and the Netherlands, the consequences for economic policy of the increasing role of China are very similar.

1 Introduction[1]

Japan and the Netherlands differ in many ways (Table 1.1). In the first place in terms of population and GDP: Japan is much bigger. Partly as a result of this, trade openness (measured by the exports to GDP ratio) is clearly less for Japan. Due to lower fertility rates and less immigration, Japan is ageing more rapidly than the Netherlands. Measured by total government outlays, the role of government is smaller in Japan. The Dutch economy performed rather well in the recent past, while Japan experienced a dismal period of deflation and low economic growth, accompanied by an extreme drop in property values. Finally, Japan is close to the most dynamic part of the world economy (emerging Asian economies), while the Netherlands are at a large distance.

There are, however, also similarities. Both countries are highly advanced economies with comparable levels of GDP per capita. Measured by the share of services in total value added,

Table 1.1 Key statistics Japan and the Netherlands

		Japan	Netherlands
Population, total (mln)	2005	127.8	16.3
Surface area (sq. km, thousands)	2005	377.9	41.5
Populations density (persons per sq. km)	2005	338	393
Life expectancy at birth, total (years)	2005	82	79
Fertility rate, total (births per woman)	2004	1.29	1.73
GDP (current dollars, bln)	2006	4367	663
GDP per capita, (in dollars at PPPs)	2006	32647	35078
Agriculture, value added (% of GDP)	2005	1.6	2.2
Industry, value added (% of GDP)	2005	22.8	18.7
Services, etc., value added (% of GDP)	2005	75.6	79.1
Trade openness (exports goods and services, % of GDP)	2006	15.9	72.2
Strictness of employment protection legislation	2003	1.9	2.3
Strictness of product market regulation	2003	1.3	1.4
General government total outlays (% of GDP)	2006	36.3	46.7
General government budget balance (% GDP)	2006	– 2.4	0.5
General government gross financial liabilities (% GDP)	2006	179.3	59.7
GDP volume growth (on average)	1997-2006	1.1	2.5
Consumer price inflation (on average)	1997-2006	– 0.1	2.2
Unemployment rate (standardised)	2006	4.1	3.9
Current account balance (% of GDP)	2006	3.9	9.0

Sources: World Bank, World Development Indicators 2007; IMF, World Economic Outlook Spring 2007, OECD, Economic Outlook No.81, Spring 2007; OECD statistical data warehouse (download June 2007).

[1] A preliminary version of this memorandum has been presented at the Osaka University Forum in Groningen on 28 June 2007. It makes use of the more elaborate study on China and the Dutch economy (Suyker and De Groot eds., 2006).

both countries are now service economies, although the industrial sector is slightly bigger in Japan.

The Japanese and Dutch economies are both influenced by the emergence of the Chinese economy in recent decades. This memorandum analyses the consequences of the rapid Chinese economic development for the two countries. Section 2 provides an overview of the most salient features; it pays attention to the impact on foreign trade, on foreign direct investment, on labour markets, on income distribution and on inflation. Section 3 aims to describe the impact of future developments in China on the two countries. Since both the developments and their associated impacts are inherently uncertain, we use simulations up to 2040 made with our WorldScan model. Section 4 concludes with a discussion of the consequences of China's emergence for Dutch and Japanese economic policy.

2 The impact of China's emergence on the Dutch and Japanese economies

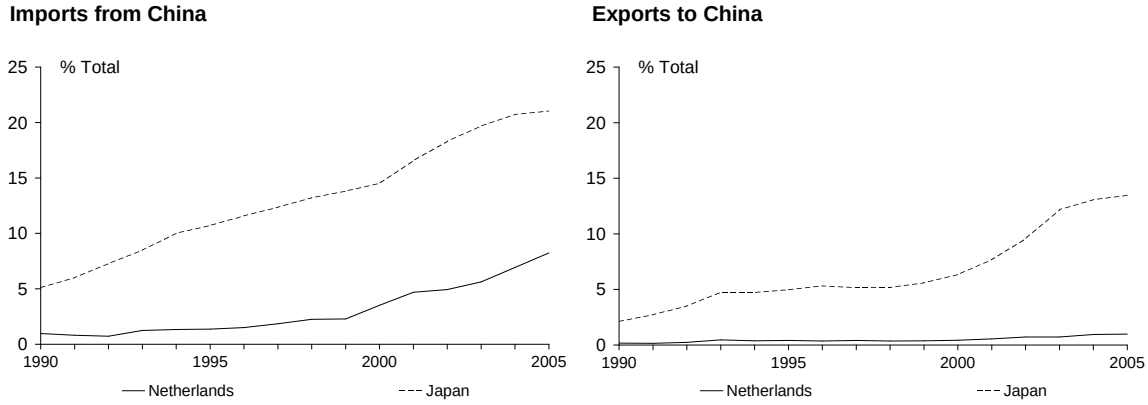
The high growth rates of the Chinese economy over the past two decades – almost 10% per year – in combination with its sheer size and its transition towards a market economy have turned China into a respectable player on the world market. This section reviews several aspects of the emergence of China for the Japanese and Dutch economies.

2.1 Impact on foreign trade

The outward-oriented Chinese economic policy has caused a steep increase in trade with the Netherlands and even more with Japan. After being flat and modest, Dutch imports from China have risen from 1.0% of total Dutch imports in 1990 to 8.2% in 2005: a rise of 7.2%-points (Figure 2.1).[2] Japanese imports from China have risen from 5.1% of total Japanese imports in 1990 to 21.0% in 2005: a rise of 15.9%-points. China is now the fourth biggest supplier of import goods for the Netherlands[3], while it is the biggest supplier for Japan (Figure 2.2).

To assess the importance of imports from China, total import penetration has to be considered. Doing so, China is more important for the Netherlands: total imports from China are 2.4% of total expenditures for Japan and 3.2% for the Netherlands.[4] This surprising result

Figure 2.1 Dutch and Japanese foreign trade with China, 1990-2005



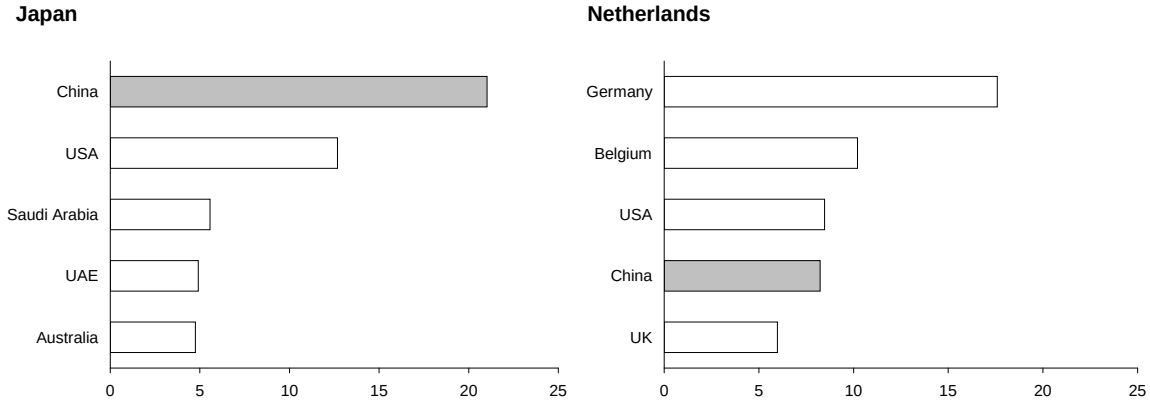
Source: OECD, International Trade by Commodity Statistics database (June 2007).

[2] This rise was steeper than elsewhere in Europe and the Netherlands have now the highest China share in imports of all EU countries.

[3] It was only the 44th supplier in 1978.

[4] Calculated as the share of Chinese imports of goods in 2005 in total imports of goods times the imports of goods and services relative to the sum of GDP and imports of goods and services (this sum equals total expenditures). This calculation somewhat overestimates the importance of China as it assumes that China is as important for import of goods as for services.

Figure 2.2 Key suppliers of import goods, Japan and the Netherlands, 2005
% of total imports



UAE: United Arab Emirates.
Source: OECD, International Trade by Commodity Statistics database (June 2007).

can be explained from the fact that most Dutch imports from China are not consumed or used in the Netherlands. Rather, two-thirds of Dutch imports from China are re-exported (CBS, 2005)[5], making the Netherlands a key European distribution centre for Chinese products.[6]

With regard to exports to China, differences between Japan and the Netherlands turn out to be huge (Figure 2.1). Since 1990, Dutch exports to China as a percentage of total exports of goods have only risen by 0.8%-points to 1.0% in 2005, while for Japan this share has risen by 11.4%-points to 13.5% in 2005. For Japan, China is the most important export market after the United States[7], while Dutch exports are mainly going to other European countries and direct exports to China are almost negligible.[8] This difference in exports to China between Japan and the Netherlands is in line with gravity models of foreign trade (Leamer, 2007; Brakman and Van Marrewijk, 2007). Taking into account the greater openness of the Dutch economy does not change the conclusion on the relative importance of exports to China: Japanese exports to China are 1.9% of GDP , much more than the 0.7% of GDP for the Netherlands.[9]

[5] In 2006, 85% of Dutch imports of computers from China are re-exported (CBS, 2007). Computers are almost 40% of total Dutch imports from China.

[6] Re-exports are defined as imported goods for which processing in the Netherlands does not lead to a shift in the first 6 numbers of the product code (Roos and Exel, 2006). This limited change indicates that the exported good is practically the same as the imported one. The increasing role of re-exports is not limited to the Netherlands (Mellens et al., 2007).

[7] The US is still by far the most important export market: 22.9% of Japanese exports is going to the United States, compared with 13.5% to China.

[8] There are indirect exports to China, but no data are available on this. For instance, the Dutch company Stork Aerospace supplies European aircraft manufacturer Airbus the electrical wiring for the A380 aircraft. Some of those aircrafts are sold to China, but the intermediate goods delivered by Stork show up in the Dutch export statistics as exports to France.

[9] Calculated as the share of Chinese exports of goods in total exports of goods times the exports of goods and services relative GDP. This calculation probably somewhat overestimates the importance of China as it assumes that China is as important for export of goods as for services. The more limited role of Chinese exports for the Netherlands is even stronger if the bigger import content is taken into account (i.e. if the share of Chinese exports is multiplied by the ratio of exports of

A detailed revealed comparative advantage analysis (Suyker and De Groot eds., 2006) shows that the Chinese and Dutch strengths on world markets do not overlap. The same may be so for the overlap between Chinese and Japanese strengths.[10] China has a comparative advantage in low-skilled goods. However, over the past twenty years it experienced an impressive increase in its ability to export several types of high-tech goods. This somewhat puzzling phenomenon is the result of a combination of factors, The presence of several foreign firms in China, the role of China as an assembler and the scale of the Chinese economy feature prominently in existing explications.

2.2 Impact on foreign direct investment

High economic growth in China has been driven by increasing openness, both to foreign trade and foreign direct investment (FDI). In contrast to other countries, FDI inflow in China continued to increase after the turn of the century, hitting a record 63 billion dollar in 2006.[11] This continuous increase is partly explained by China's accession to the WTO. FDI inflow into China is rather stable, at some 3% of GDP, exceeding that of France and the United States. China attracts the bulk of FDI flows to emerging economies, although its share has fallen from a peak of 39% in 2003 to 26% in 2006 (BIS, 2007). Direct investment in China has traditionally taken the form of greenfield projects. In the past few years, however, cross-border mergers and acquisitions grew in importance. The Chinese government stimulates FDI inflow by fiscal facilities, depending on the sector and the region.

Japan is investing much more in China than the Netherlands (Figure 2.3). At the end of 2005, the total stock of Japanese FDI in China amounted to 26 billion dollar, substantially above the 2 billion dollar invested by Dutch firms. Relative to GDP, Japan is clearly a bigger investor too.

While the Netherlands is only a minor investor in China, Japan is the third biggest. On average in 2001-2005, 33% of the FDI inflow into China came from Hong Kong, 15% from the Virgin and Cayman Islands and 10% from Japan. The Virgin and Cayman Islands are off-shorefinancial centres and their investments in China originate of course from elsewhere. As for the high share of Hong Kong, the neighbouring position plays a part. The figure for Hong Kong

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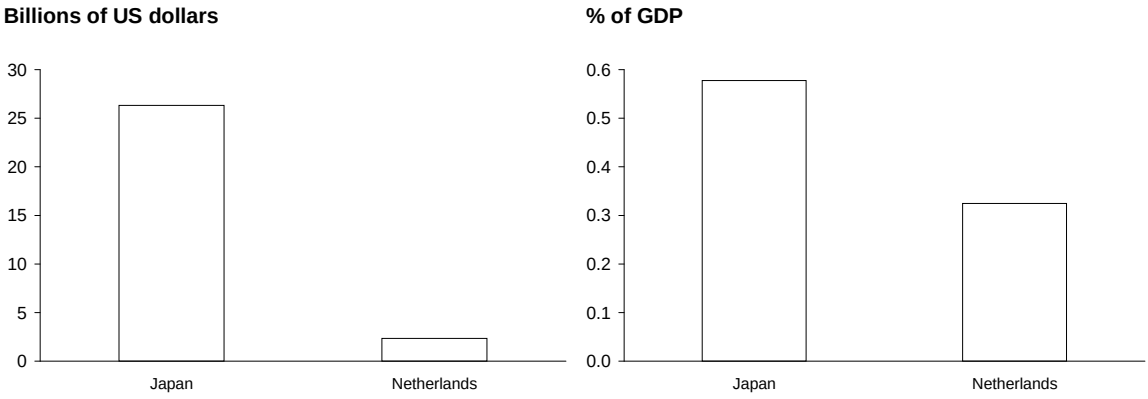
goods and services relative to the sum of GDP and imports of goods and services). This indicator is 0.4% for the Netherlands and 1.9% for Japan.

[10] According to Chi Hung Kwan of the Nomura Institute of Capital Markets Research, Japan's exports to the US are not even in competition with those from China, since the two countries produce radically different products (Giles, 2007; Kwan, 2007).

[11] This concerns FDI to non-financial sectors as reported by the National Bureau of Statistics of China (2007). FDI inflows in the two previous years were also around 60 billion dollars. According to the People Bank of China (2007), total FDI amounted to 69.5 billion dollars in 2006, marginally less than in 2005 (People Bank of China, 2007).

Figure 2.3 Dutch and Japanese Foreign Direct Investment in China, outstanding stocks



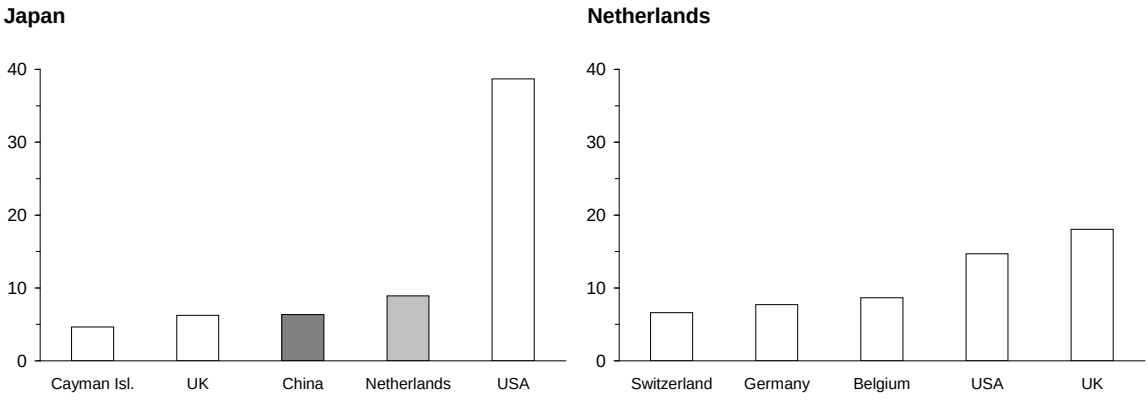
Source: De Nederlandsche Bank and Bank of Japan, FDI statistics.

is, however, biased upwards because some domestic Chinese enterprises channel their investment in China through Hong Kong in order to benefit, as a "foreign" investor, from tax breaks. The size of this "round tripping" is not known. Some estimate it at 20% of the official figure of Hong Kong FDI in mainland China (Unctad, 2005).

Thus, given the peculiarities of Hong Kong and of the Virgin and Cayman Islands, it is justified to conclude that Japan can be seen as the biggest foreign investor in China. In 2001-2004, 17% of incoming FDI into China (excluding Hong Kong, the Virgin Islands and the Cayman Islands) came from Japan, compared with 16% from the United States and 14% from the EU-15.

While Japan is the biggest investor in China, it is clearly not the major destination of Japanese FDI (Figure 2.4). Almost 40% of its overseas investment is located in the United States. This is not surprising as FDI takes mainly place between advanced economies (OECD, 2006b).

Figure 2.4 Key FDI destinations, Netherlands and Japan, 2005
% of outstanding stocks



Source: De Nederlandsche Bank and Bank of Japan, FDI statistics.

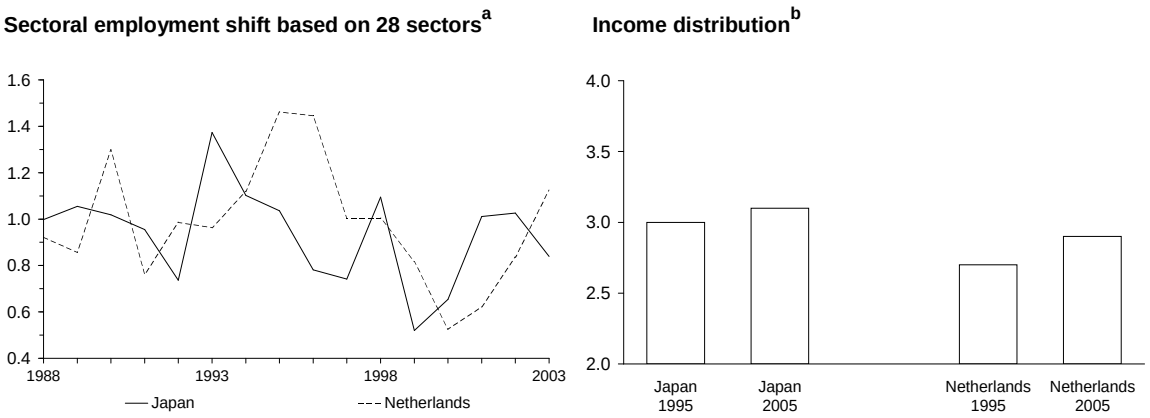
Surprising, however, is that Japan has invested more in the Netherlands than in China. This may have to do with the role of the Netherlands as European distribution centre, but possibly also with its attractive tax treatment of foreign subsidiaries. Like the Cayman Islands, the Netherlands could be an offshore financial centre for Japanese multinationals.

2.3 Impact on labour markets and income distribution

In both the Dutch and Japanese popular press, frequent claims are made that globalisation will cause huge labour market adjustments and strong increases in income inequality.[12] Similar claims are also made in relation to the emergence of China and its increasing importance in the world economy. With respect to both labour market adjustments and income distribution, the bare facts suggest otherwise and point at a relatively modest impact of globalisation in general (and the emergence of China in particular).

Considering labour market adjustments, a simple look at the facts makes clear that the recent steep increase in trade with China does not have a noticeable impact on the pace of restructuring or on unemployment (Figure 2.5). In 2001-2004, 0.4% of Dutch and 0.8% of Japanese employees shifted each year from one sector to another. This was less than in the previous 15 years, when it was 1.0% for the Netherlands and 1.1% for Japan. The lower pace of changes in the Dutch sectoral pattern fits with other indications of limited outsourcing of Dutch firms to foreign countries (Gorter et al., 2005).

Figure 2.5 Globalisation and labour markets



[a] Sum of absolute values of changes in sectoral employment shares divided by two.
[b] Ratio of the 90th to the 10th percentile earnings.
Sources: Own calculations based on OECD Structural Analysis Database, OECD Employment Outlook 2007.

[12] This fits with the analysis of Bryan Caplan (2007). He concludes voters have an anti-market bias, an anti-foreign bias, overemphasise jobs relative to income and are too pessimistic.

Measured by the ratio of the highest to the lowest earnings, income inequality has risen somewhat in the Netherlands and Japan in the past 10 years (Figure 2.5).[13] A consensus seems to have emerged in the literature that the effect of globalisation on income inequality is limited. The primary suspect for explaining the observed increase in income inequality is biased technological progress, which can be interpreted as a demand factor in favour of high-skilled workers. In addition, the increased capital intensity of developed economies seems to be an important factor, caused by the complementarity between physical and human capital. In the case of Japan, increased labour market dualism and ageing may also have contributed to a rise in income inequality (Jones, 2007).

2.4 Impact on inflation and interest rates

In recent years, increasing imports from China have lowered Dutch and Japanese inflation and have increased purchasing power of households. The OECD estimates a dampening impact of globalisation on inflation of 0.0-0.3%-points per year for the Netherlands and 0.0-0.1% for Japan (Table 2.1).[14] The dampening impact on inflation may be less positive for Japan than for the Netherlands as it aggravated the deflation problem. However, also for Japan, the drop in import prices means a positive impact on the terms of trade and on the purchasing power of households.

Table 2.1 Impact of globalisation on inflation and purchasing power of households (–), 2000-2005, % and %-points per year

	Average annual inflation (actual, in %)	Globalisation effects: Non-commodity effect Minimum	Non-commodity effect Maximum	Commodity effect Minimum	Commodity effect Maximum	Net effect Minimum	Net effect Maximum
Euro area	2.1	– 0.2	– 0.3	0.1	0.1	0.0	– 0.3
of which Netherlands	2.7	– 0.2	– 0.4	0.1	0.2	0.0	– 0.3
Japan	– 1.0	– 0.1	– 0.1	0.1	0.1	0.0	– 0.1
United States	2.2	– 0.2	– 0.3	0.1	0.1	0.0	– 0.3
OECD	1.8	– 0.1	– 0.3	0.1	0.1	0.0	-0.2

Source: Pain et al., Globalisation and inflation in the OECD countries, OECD Economics Department working paper 524, 2006.

The positive impact on purchasing power is mostly due to the increased import share of low-cost products of China and other emerging countries. The price level differential between import goods from China and goods produced in advanced economies like Japan ant the

[13] However, measured by the Gini-coefficient, there is no increase in Dutch income inequality (Irrgang and Hoeberichts, 2006).

[14] The dampening impact of Chinese imports alone is estimated at 0.2%-points in 2001-2005 for the Netherlands and the other euro area countries (OECD, 2006a). As a result, total consumption of Dutch households is around 300 euro per year cheaper.

Netherlands is estimated at 49% in 2001-2005 (OECD, 2006). This impact of lower import prices of manufactured goods is partly offset by higher import prices of oil and other commodities.

The calculation reported here does not take into account the probably non-negligible effect of the fall in producer prices in the mature economies due to global competition forces. Neither does it take into account the possible downward pressure globalisation puts on wages in advanced economies. Furthermore, the estimate of the dampening effect on inflation of trade with China should be treated cautiously. Inflation in the medium term can be seen as set by central banks in case of credible and effective monetary policy.

In recent years, China's export-led growth created a huge surplus on its current account and caused an enormous build-up of international reserves. The current account surplus is projected to rise further, from 250 billion US dollar in 2006 to 340 billion US dollar in 2007; in 2003 the surplus amounted to no more than 46 billion US dollar (World Bank, 2007b). The international reserves surpassed 1000 billion US dollar in the course of 2006 and are projected at almost 1400 billion US dollar in 2007; in 2003 the reserves were 400 billion US dollar.

The increase in international reserves of China and the rest of Asia may have reduced global interest rates in 2005 by almost 1%-point (Hauner and Kumar, 2006). This corresponds with the "educated guess" by prominent economists and fixed-income market analysts reported by the ECB (2006a) and is somewhat bigger than the dampening of 0.6%-point estimated by Warnock and Warnock (2005).[15]

A lower interest rate has a noticeable impact on the Dutch and Japanese economies in the medium term. According to simulations with the CPB macro-economic model SAFFIER, a drop in the Dutch long-term interest rate by 1%-point increases Dutch real GDP by 1.2% in the fourth year after the drop and lowers the unemployment rate in that year by 0.6%-points (Kranendonk and Verbruggen, 2007).

[15] The view of a dampening effect of the increase in international reserves on interest rates is broadly but not universally shared (see for instance Rudebusch et al., 2006).

3 Long-term scenarios for China

This section aims to outline the possible impacts of future developments in China on Japan and the Netherlands. Both the developments and their associated impacts are inherently uncertain. We explore these uncertainties using CPB's WorldScan model.[16] In order to illustrate the impact of different developments, two scenarios are constructed.[17] They are the two extreme outcomes of the globalisation process: the Global Economy (GE) scenario and the Regional Communities (RC) scenario. A high growth pattern for China is exogenously simulated in the GE scenario and a lower growth pattern in the RC scenario. Thus, a wide spectrum of outcomes is obtained. The scenarios do not aim to predict the future, but rather to sketch alternative futures. Both scenarios are feasible and consistent views of the world economy.

The Global Economy Scenario

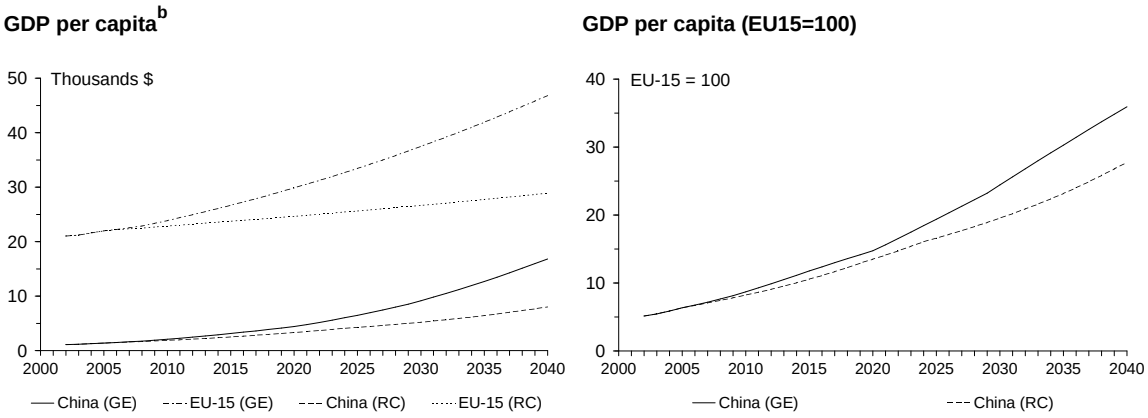
In the Global Economy scenario world trade and global economic growth are boosted by trade liberalisation, economic integration and the policy emphasis on market efficiency. New international trade agreements result in significant reductions in barriers to trade (tariffs and non-tariff barriers). Innovation and international competition spur labour productivity worldwide. As a consequence of the smooth functioning of national and international goods and services markets, China's economic growth remains very high: 8.5% per year up to 2020 (Table 3.1). After 2020, economic growth diminishes, but remains high. Due to sharp productivity increases, China's GDP per capita rises strongly, from 5% of the EU-15 level (measured in exchange rates) in 2000 to 15% in 2020 and 36% in 2040 (Figure 3.1). This rapid development also means that China's share in world production increases strongly, surpassing that of the EU-15 at the end of the period (Figure 3.2). Measured by the average of exports and imports as a percentage of GDP, openness of the Chinese economy increases by about 9%-points. High growth in China and the rest of dynamic Asia redirects European and Japanese trade flows towards that region. From 2006 to 2040, total Chinese exports to the EU-15 increase by almost 24 times, i.e. 10% per annum. The equivalent number for European exports to China is 11 times. As there is stronger competition with China and other dynamic Asian countries, the fall in the export share of manufacturing is sharp for the EU-15. There is also further specialisation in the sectoral pattern of trade. Chinese exports of other manufacturing and

[16] WorldScan, CPB's applied general equilibrium model for the world economy, has recently been described in detail in Lejour et al. (2006). It is recursively dynamic and reflects the global economy with multi-region and multi-sector detail, the regions being connected by bilateral trade flows at industry level. WorldScan fits into the tradition of applied general equilibrium models: it builds upon neoclassical theory, has strong micro-foundations and explicitly determines simultaneous equilibrium on a large number of markets.

[17] The scenarios presented here and in Suyker and the Groot (2007) build on previous long-term analyses (Lejour, 2003; De Mooij and Tang, 2003). The sectoral classification is the same, but China and India are now separate regions while they were part of the "rest of the world" region before. This disaggregation of the "rest of the world" and other minor modifications lead to outcomes for the EU-15 diverging somewhat from Lejour (2003).

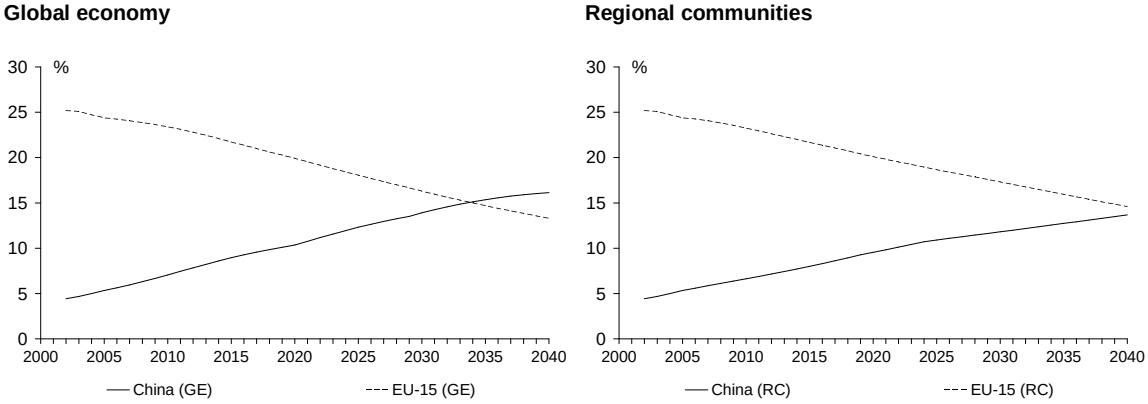
capital goods represent 78% of their total exports to the EU-15 in 2040, while European export growth to China will consist mainly of services.

Figure 3.1 GDP per capita of China and the EU-15[a], 2000-2040



[a] GE: Global Economy, RC: Regional Communities.
[b] In prices of 2001; measured at exchange rates.
Source: Suyker and De Groot (eds., 2007).

Figure 3.2 Shares in world GDP[a,b] of China and the EU-15, 2000-2040



[a] GE: Global Economy, RC: Regional Communities.
[b] In prices of 2001; measured at exchange rates.
Source: Suyker and De Groot (eds., 2007).

Trade liberalisation and the policy emphasis on more private responsibilities not only boost output growth of China but also that of the EU-15 and Japan. High GDP growth in the EU-15 is accompanied by a wider income dispersion. The ratio of unskilled to skilled wages is expected to widen, from an EU-15 average of 0.62 in 2002 to 0.52 in 2040. However, the unemployment rate drops as there are stronger incentives for the unemployed to find a job and as the costs for employers of attracting employees fall.

Table 3.1 GDP growth, annual averages 2002-2040

		Regional communities		Global economy	
	02-05	06-20	21-40	00-20	21-40
China	9.1	6.5	4.4	8.5	6.9
EU-15	1.7	1.1	1.0	2.4	2.3
New EU members	2.8	2.2	1.8	4.6	4.9
Candidate members	3.7	3.5	3.4	7.0	6.6
Japan, US and rest OECD	2.3	1.7	1.4	2.8	2.7
Former Soviet Union	6.1	4.6	5.1	5.5	5.5
India	6.8	5.6	5.6	8.1	6.6
Rest of the World	3.1	4.2	4.7	5.7	7.4
All regions	2.7	2.4	2.4	3.7	4.2

Source: Suyker and De Groot (eds., 2007).

The Regional Community Scenario

In the Regional Communities (RC) scenario world trade and global economic growth is lower than in the Global Economy (GE) scenario because of a lack of international cooperation, more stringent regulation and limited scope for private initiative. The world fragments into a number of trade blocks and technology spillovers to emerging economies are small. Globally, there is no further reduction in trade tariffs, but there are more regional trade agreements, for instance between China and the rest of dynamic Asia. As a consequence of more trade barriers and less incentives, China's economic growth is weaker than in the Global Economy scenario: 6.5% per year up to 2020 (Table 3.1). Therefore, China's convergence is slower, although growth in high-income countries is weaker as well. Growth in world exports is limited, and the share of intra-EU trade remains relatively high. Openness of the Chinese economy falls by about 6%-points.

In contrast to the Global Economy scenario, output growth in the EU-15 and in Japan is less than in the recent past. This is the result of low productivity growth and of a decline in the labour force due to ageing and restrictive immigration policies. Income dispersion is not expected to rise significantly in this scenario, while the unemployment rate of the EU-15 remains unchanged and the employment increase is rather modest.

The two scenarios do not only differ at a macro level but also at a sectoral level. The share of the service sector varies because of different developments in per capita income in combination with relatively high income elasticities for consumer services. Hence, output growth of service sectors is higher in the Global Economy scenario than in the Regional Communities scenario. This is the case in China, EU-15 and Japan. The flipside of the bigger share of services in total value added is a decline of the shares of the agricultural and manufacturing sectors. In China,

the output share of agriculture falls steeply, but remains substantially bigger than in the EU-15 and in Japan.

Summing up

To sum up, the most significant development in both scenarios is the considerable increase in bilateral trade flows between China and the rest of the world. If the proper conditions are in place, the same holds for the flows between the Netherlands and China and between Japan and China. While the changes are much more pronounced in the Global Economy scenario, they are also significant even when trade barriers are left at roughly the same levels as in 2002. Increased trade flows, however, are only partially responsible for the significant labour and production reallocation towards the services sectors expected to take place in Japan and the EU-15, including the Netherlands (Huizinga and Smid, 2004).

4 What does China's development mean for Dutch and Japanese economic policy?

With regard to "China" and economic policy in the Netherlands and Japan, a distinction has to be made between specific promotion measures, trade policy and other economic policy measures.

As regards promotion measures, it is clear from the continuing strong expansion of the Chinese economy that China has to be a spearhead in trade promotion, aimed at supporting companies in competing in the vast Chinese market. Provision of such trade information is at least partly a public good, lowers transaction costs and therefore strengthens the position as a trading nation (WRR, 2003).

Furthermore, with the emergence of Chinese multinationals, their search for a region to locate their European head office and the likely positive external effects of such locations, it is also clear that in order to attract foreign direct investment in the Netherlands, the Netherlands Foreign Investment Agency (NFIA) has to pay substantial attention to China.

Concerning trade policy, the focus has to be on the opening-up of the Chinese services sector and on protection and enforcement of international property rights in China. Worries about technology leaks hamper foreign direct investment of Dutch and Japanese enterprises in China as such leaks can be detrimental. The opening-up of the Chinese services sector has been agreed upon as part of the accession of China to the WTO, but it still has to be implemented in the coming years. More in general, the focus of trade policy has to be on supporting a level playing field with China. This includes compliance with WTO-requirements, respect of ILO-prescriptions on working conditions and a transformation of the Chinese economy into a more environmentally sustainable direction.

As for other economic policy measures, the emergence of China only has a limited impact (see also Box "Ten Do's and don'ts of economic policy reactions to China" on page 17). The same holds for globalisation in general. It is important to underline that further globalisation, including the emergence of China, is likely to enhance Dutch and Japanese welfare.[18]

No major acceleration in restructuring is foreseen in the long-term scenarios presented in Section 3. Increased trade flows will only be partially responsible for future labour and

[18] According to model simulations of the European Commission, exploiting the opportunities offered by the present globalisation phase could bring additional income gains of over €5000 annually, in 2004 prices, for every EU household (Denis et al., 2006).

production reallocation towards the services sectors in the Netherlands and Japan. Nevertheless, as more trade with China will lead to some restructuring, labour market policies aimed at lowering adjustment costs are relevant. Workers in advanced countries losing their job in import-competing industries have somewhat bigger problems in finding a new job than other job losers (OECD, 2005 and 2005b, OECD, 2007). Thus, some spending on retraining programmes is warranted to smooth the adjustment. It has to be taken into account, however, that efforts to find re-employment in a comparable job and industry may be more cost-effective than retraining for a job in a very different industry. Even in declining industries labour turnover is high and allows job losers to find new work.

Globalisation-induced restructuring may lead to some reappraisal of the economic role of unemployment insurance schemes. Such schemes play an important role in cushioning the impact of trade-related job displacement, leading to a more even distribution of benefits and costs of international economic integration. Moreover, unemployment insurance schemes allow job losers to search for a new job that fits their skills well. These assessments of the OECD are consistent with the conclusion in De Mooij (2006) that the insurance function of the welfare state renders an important condition for internationalisation ("greasing the wheels").

No doubt globalisation sharpens competition. Rents of production factors, that is factor remuneration above market rates, will therefore fall. Remunerations will reflect more closely the (deep) comparative advantages of a country. Policy should foster these existing comparative advantages, not by old-fashioned industrial policy but by creating the proper framework conditions.

Furthermore, the fact that two-thirds of Chinese imports are re-exported shows the importance of the role of the Netherlands as European distribution centre. Currently, every day more than 1000 two-container trucks are coming from the Rotterdam harbours loaded with Chinese products. Almost the same amount of "Chinese" containers are transported by ship out of Rotterdam. Proper transport infrastructure is needed to tap the gains of the increasing role of China as supplier of goods to Europe. In decisions on infrastructural projects not only these benefits but also possible negative external effects on the environment have to be taken into account (CPB et al., 2006).

Finally, strengthening Dutch and Japanese comparative advantages demands innovation. With regard to Dutch education, there are several promising policy options to increase welfare (Cornet et al., 2006). About Dutch R&D policy, there is less consensus and more debate. Cornet and Van de Ven (2004) conclude that more R&D would enhance Dutch welfare. Empirical research shows, however, that it is difficult to introduce policy measures that increase R&D (Cornet et al., 2006). This holds even more for sector-specific measures. There is no convincing

empirical evidence showing that governments are able “to pick the winners”. More promising are general measures that provide incentives for young innovative firms to enhance R&D. The same holds for measures to boost the provision of risk capital. A warm welcome to high-skilled foreigners could also boost the innovative capacity of the Dutch and Japanese economies. In this context, the rising number of Chinese scientists and engineers can be seen as an opportunity.

Ten Do’s and don’ts of economic policy reactions to China

I Do not panic on China/globalisation as the net welfare effects are positive for the Netherlands and Japan.

II As the net effects are positive and the negative effects are relatively small and mostly temporary, there is no reason for major policy shifts.

III. Do not blame China/globalisation for every difficult but necessary measure to be taken.

IV. Refrain from trying to halt unavoidable adjustments stemming from China/globalisation. The global division of labour will change and more low-skilled Dutch and Japanese workers will have to shift to jobs in the nontradable sector.

V. Acknowledge the costs of adjustment prompted by China/globalisation. Smooth required adjustments mainly by general policy measures (the unemployment insurance scheme and retraining programmes).

VI. Foster the existing comparative advantages of the Dutch and Japanese economies. Do this by creating the proper framework conditions.

VII. In the case of the Netherlands, exploit the comparative advantages that give rise to the role as a gateway to Europe, while also acknowledging and monitoring the potential negative effects in terms of, for example, increased congestion and negative environmental effects.

VIII. Monitor the opening-up of the Chinese service market closely as it is of great importance for Dutch and Japanese financial companies and other service providers.

IX. Support multilateral initiatives to promote a level playing field with China. This has to result in equal rules for all regarding market access, compliance with WTO-requirements, respect of ILO-prescriptions and a transformation of the Chinese economy into a more environmentally sustainable direction.

X. Acknowledge the specificities of trade with and investing in China that translate into relatively high transaction costs and aim at lowering informal transaction costs.

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